The Great Leveraging

Five Facts and Five Lessons for Policymakers

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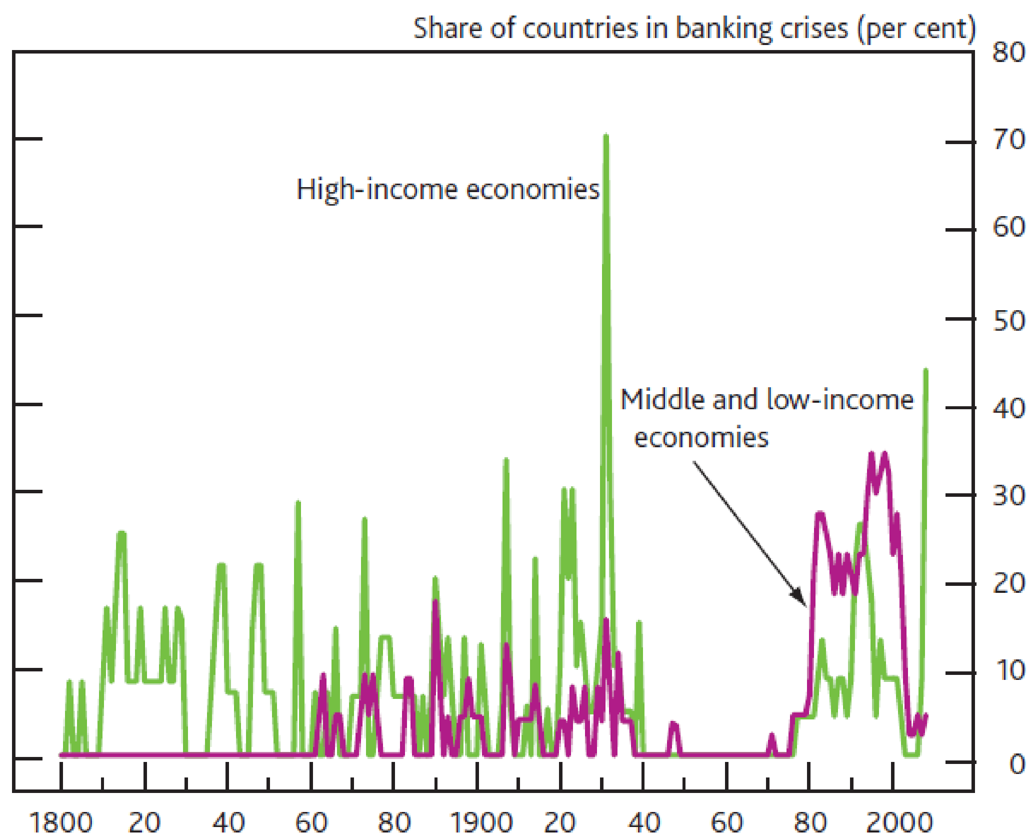
<u>Fact 1. Crises</u>: Almost forgotten: now they're back

- A long standing problem
  - For DM and EM

- Exception: 1940 to 1970 period unusually quiescent. Why?
  - ***Internal or external constraints?***



Source: Qian, Reinhart and Rogoff (2010).

<u>Fact 2. Consequences</u>: forgot depressing/deflationary impacts

- Evidence-based macroeconomics
  - Event study
  - 14 “advanced” countries
  - 140 years of data

- Recessions are painful
  - Those with financial crises are more painful
  - *Those with global financial crises are worse still*

- Prewar versus Postwar

Chart 4a

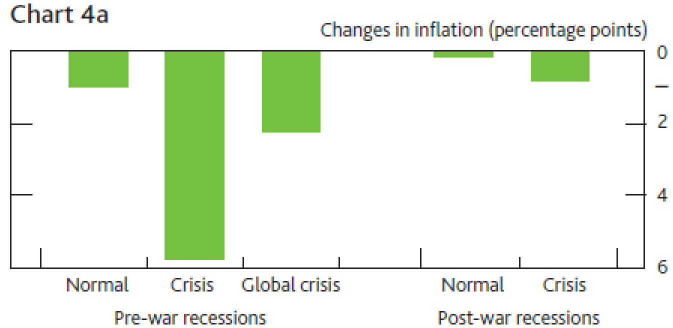


Chart 4b

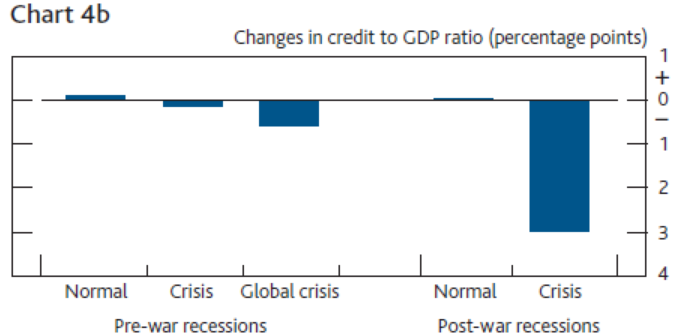
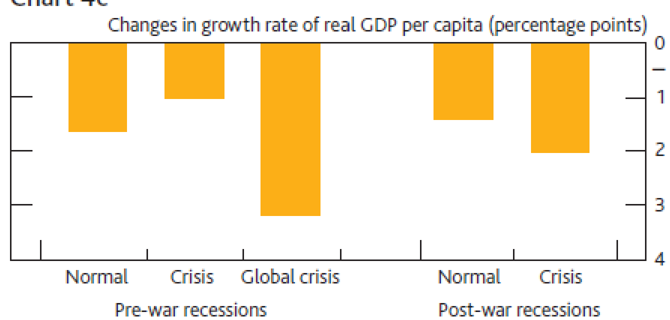


Chart 4c

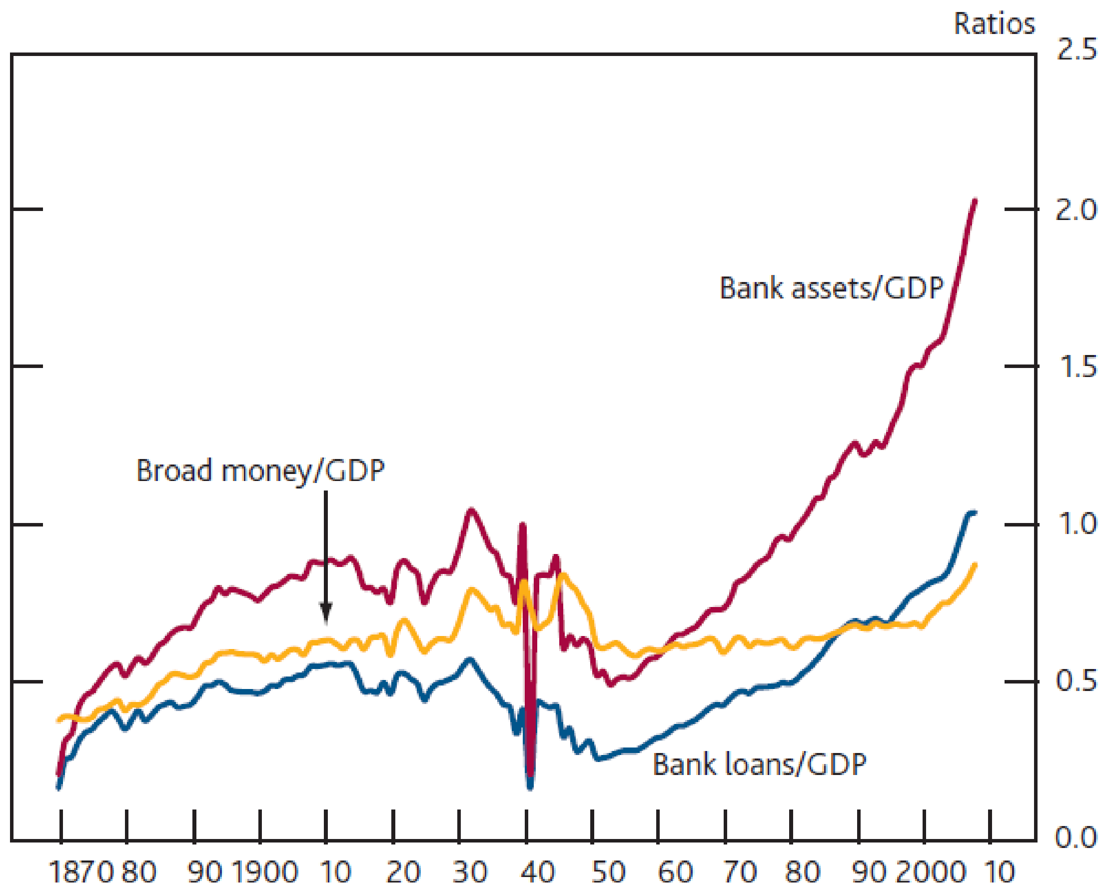


Source: Jordà, Schularick and Taylor (2010).

(a) Four-year windows before/after recession peak.

Fact 3. Extreme leverage: historically unprecedented

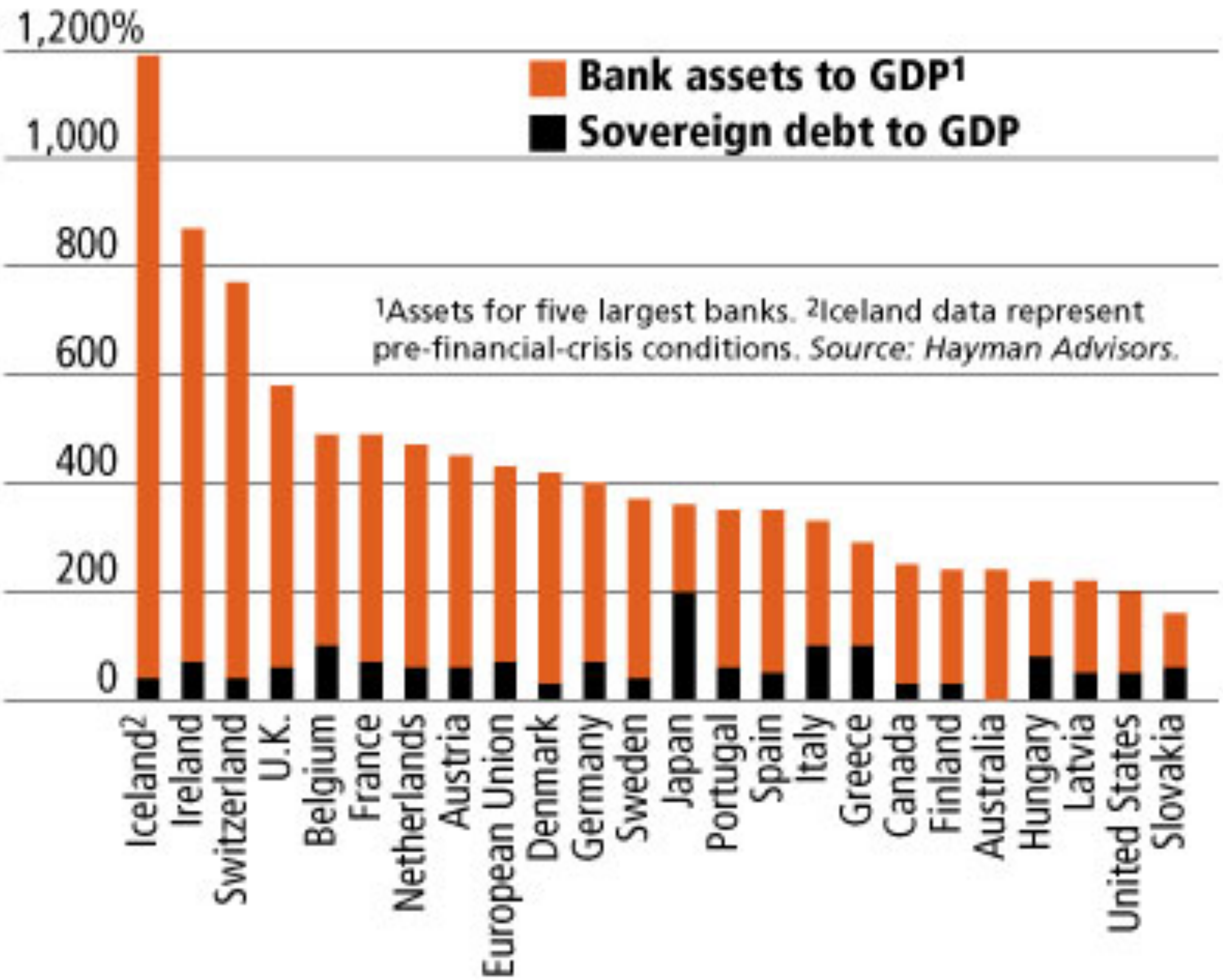
- Then
  - Age of Money
- Now
  - Age of Credit
- How?
  - More leverage
  - Wholesale funding
- Why?
  - Private actions (recovery from GD/WW2)
  - Government policies (financial liberalizations)



Source: Schularick and Taylor (2009).

(a) Fourteen-country averages by year.

Banks versus Sovereigns



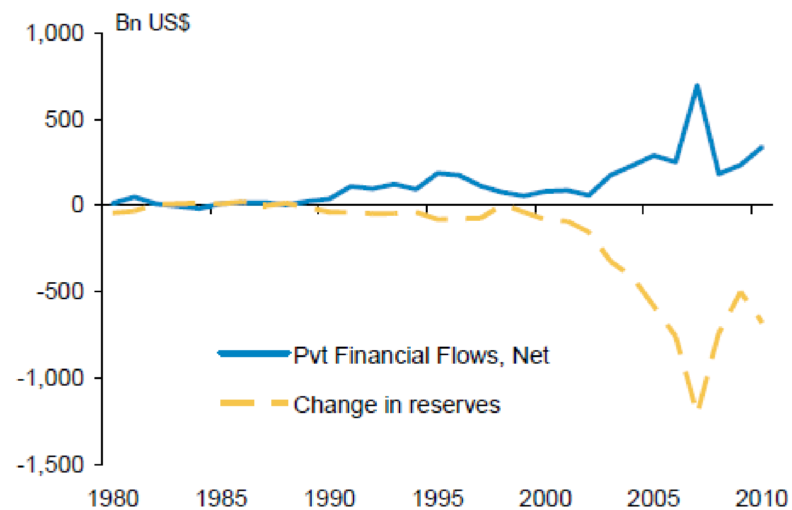
2010 data.

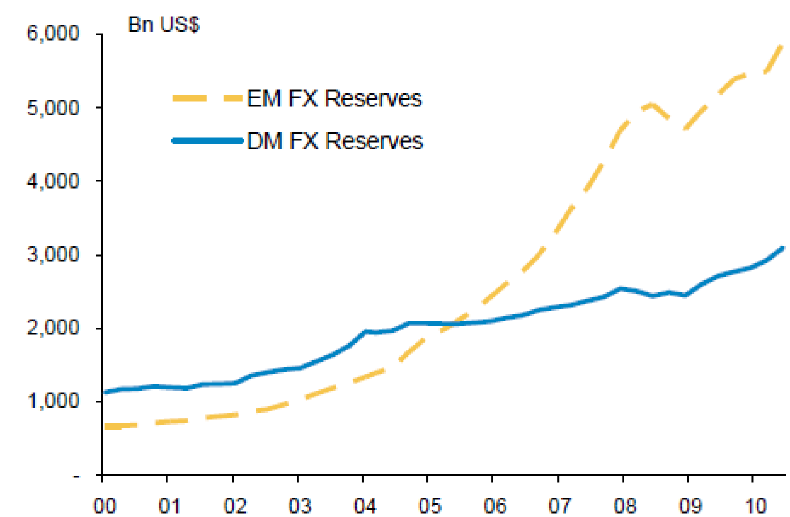
Where is the risk in this picture?

Fact 4. Global asymmetry: EMs buy insurance, DMs sell it

- Post-1990s EMs switch to safer, countercyclical polices and larger buffers
- "Great Reserve Accumulation"
  - Unique phase in history?
  - Gold standard
- Net capital flows
  - Private inflows
  - Official outflows
- Is there really a "Lucas paradox"?

EM Economies, Official Reserves,
(a) Flows and (b) Stocks





Source: IMF IFS, Haver

Fact 5. Savings glut: short run panic v. long run demography

- Short term reasons to think the era of cheap capital is over
  - Investment rebound in EM and DM? Not yet!
  - EM reserve "step change" completed?
  - DM delevering slow?

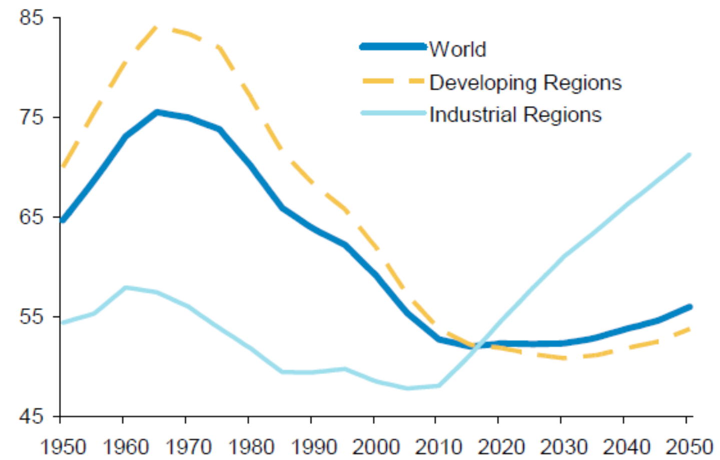
- Longer term reasons?
  - Demography

- Offsetting/postponing factor
  - Recurrent and ongoing flights to safety

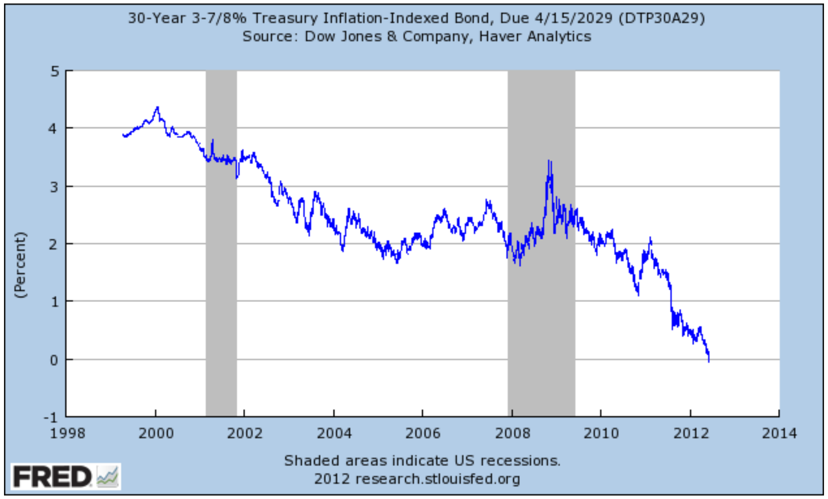
- Real rate = 0% in Jun 2012!

Global Dependency Ratios

Dependents (0-14, 65+) per 100 working age (15-64)



Source: UN/Haver. Estimates 1950-2009, projections 2010-50

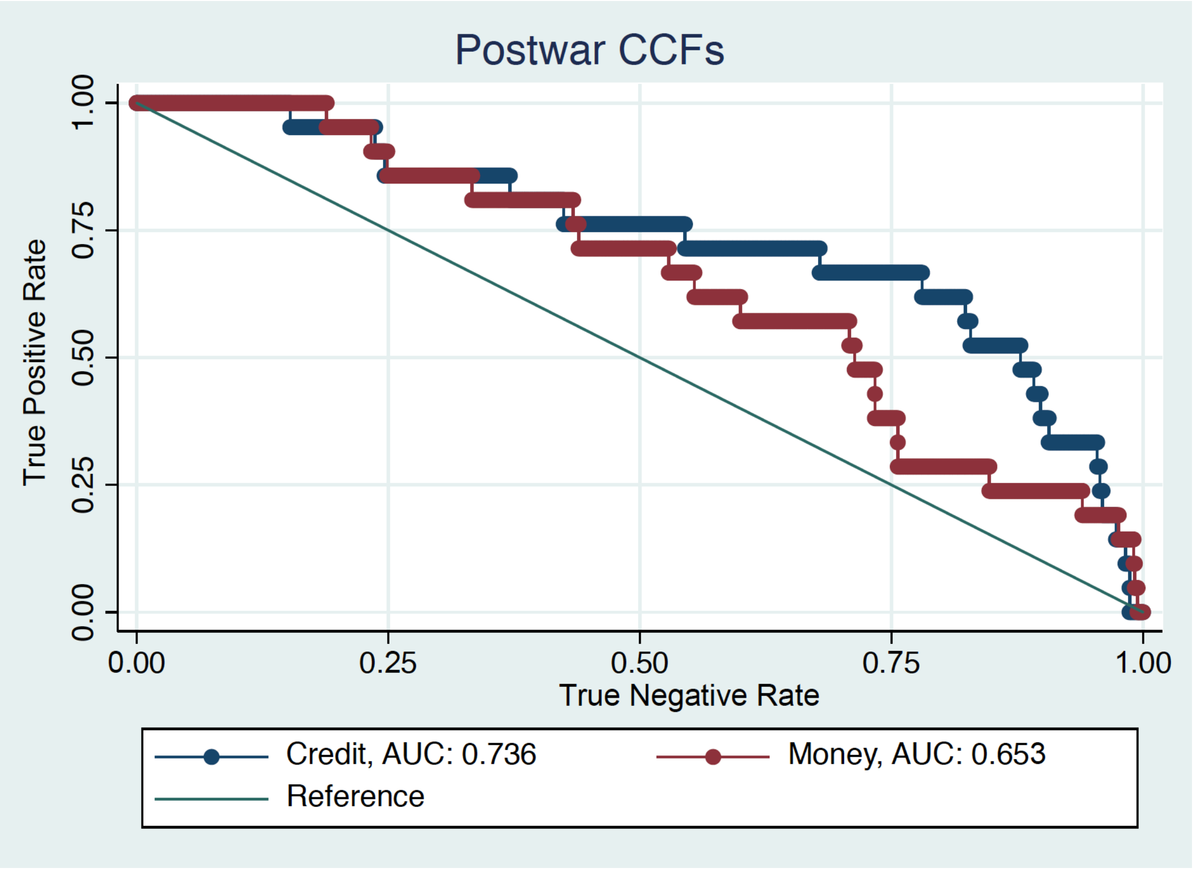


Summing up the facts

- An Inconvenient Truth
  - Crises just a fact of life in modern finance capitalism?
  - Exception was 1950–70 with financial repression, regulation, controls.
  - Period of low credit creation. But it was also still a period of high growth.
- Plus A Series of Unfortunate Events
  - Cheap capital in asymmetric world. Credit boom.
  - Good = productive projects. Bad = risk of boom-bust cycle.
- Sequel
  - Hunger for safe assets, demographic shifts slow (but coming).
  - Low real rates for now= deflationary shock continues, and credible sovereigns can be funded.
- Next
  - What lessons for policy in this kind of financial landscape
  - Macro policy / Financial policy

Lesson 1: Past private credit growth does contain valuable predictive information about likelihood of a crisis

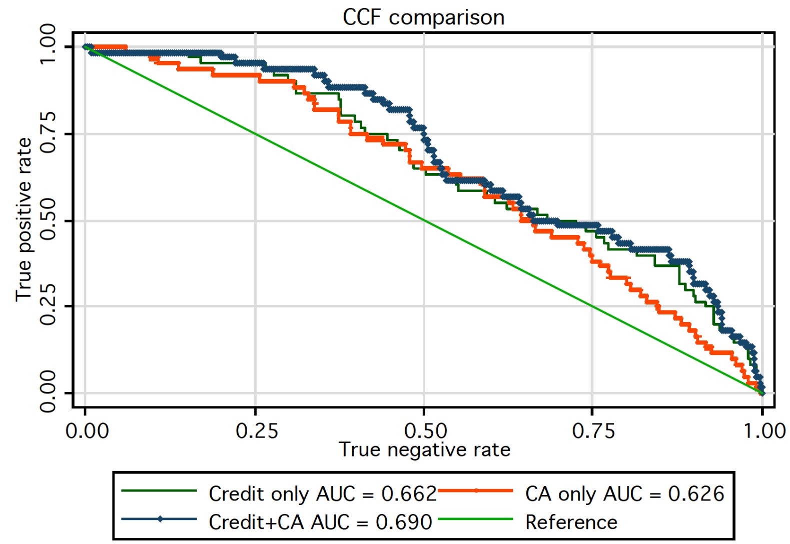
- Schularick and Taylor 2012 AER "Credit Booms Gone Bust"
- Use lagged credit growth T–5,..,T–1
- Forecast of a financial crisis {0,1} in year T
- Beats null (cointoss)
  - More so that narrow or broad money
  - Robust to other controls including macro, interest rates, and stock prices

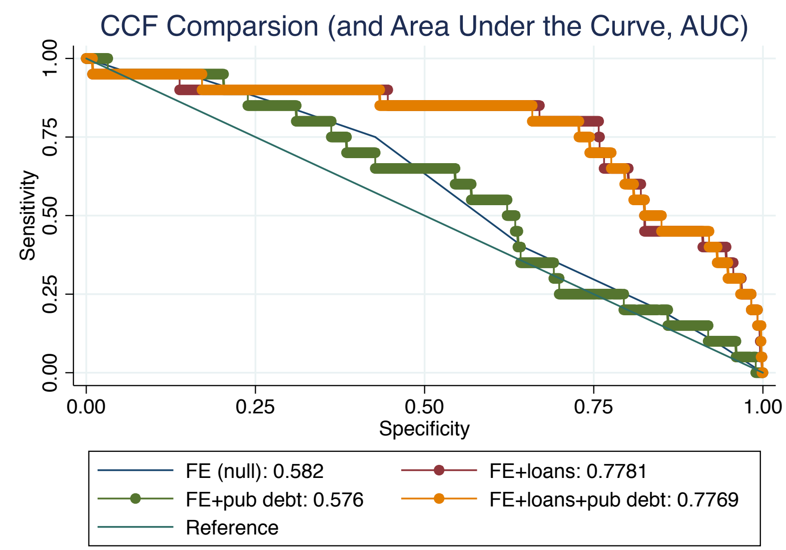


Lesson 2: External imbalances/public debts are a distraction

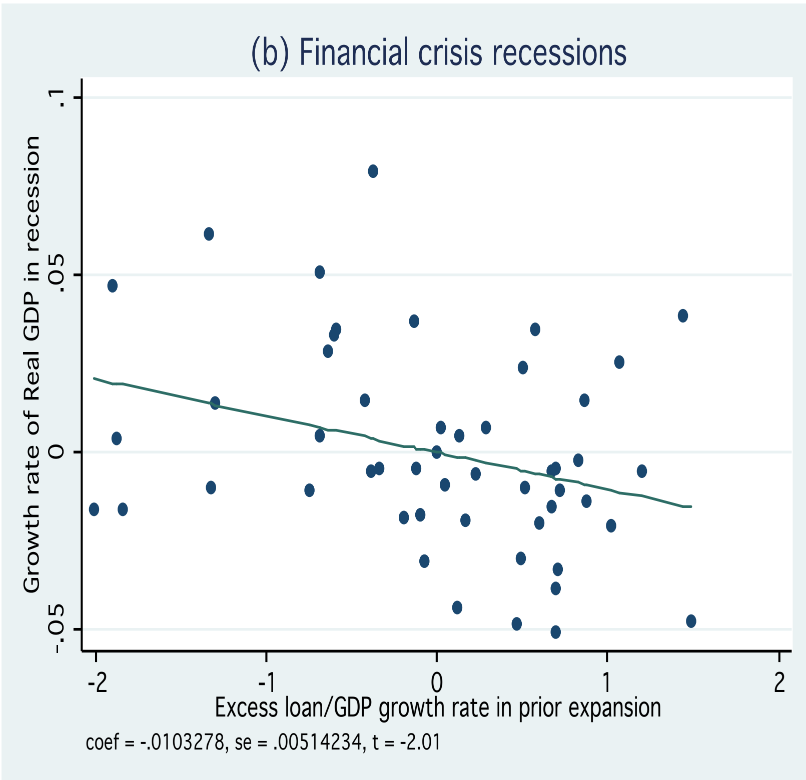
- Jordà, Schularick, Taylor 2011 IMF Economic Review "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons"

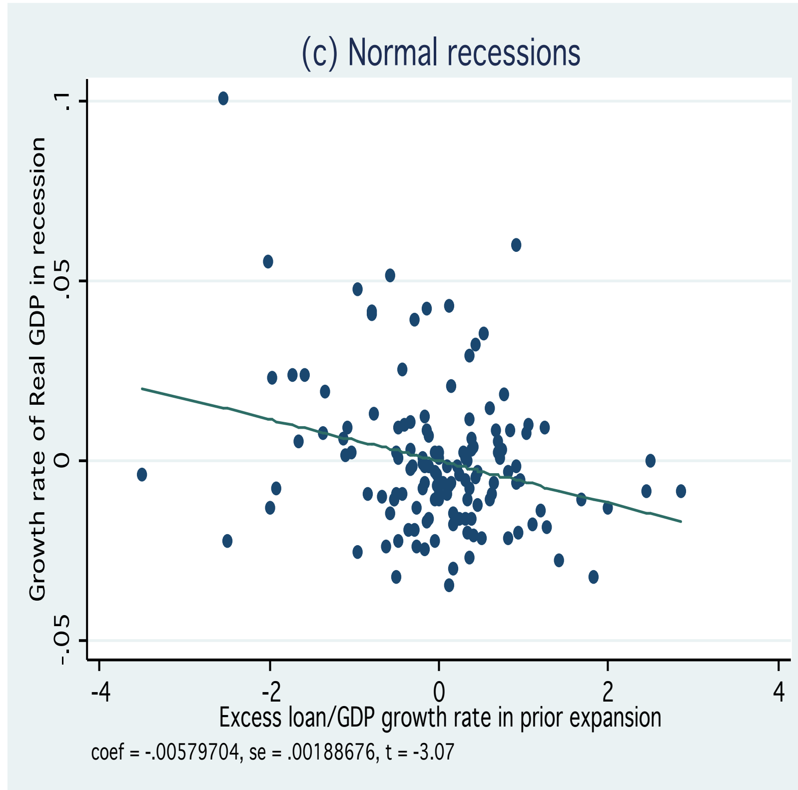
- Couldn't it all be down to external imbalances rather than internal?
- Add current account (%GDP) to the forecast system and run a horse race.
- As a policymaker, which signal has more valuable information about incipient financial fragility?
- Not CA/GDP
- Same result holds for public debt/GDP





Lesson 3: After a credit boom, expect a more painful "normal recession"

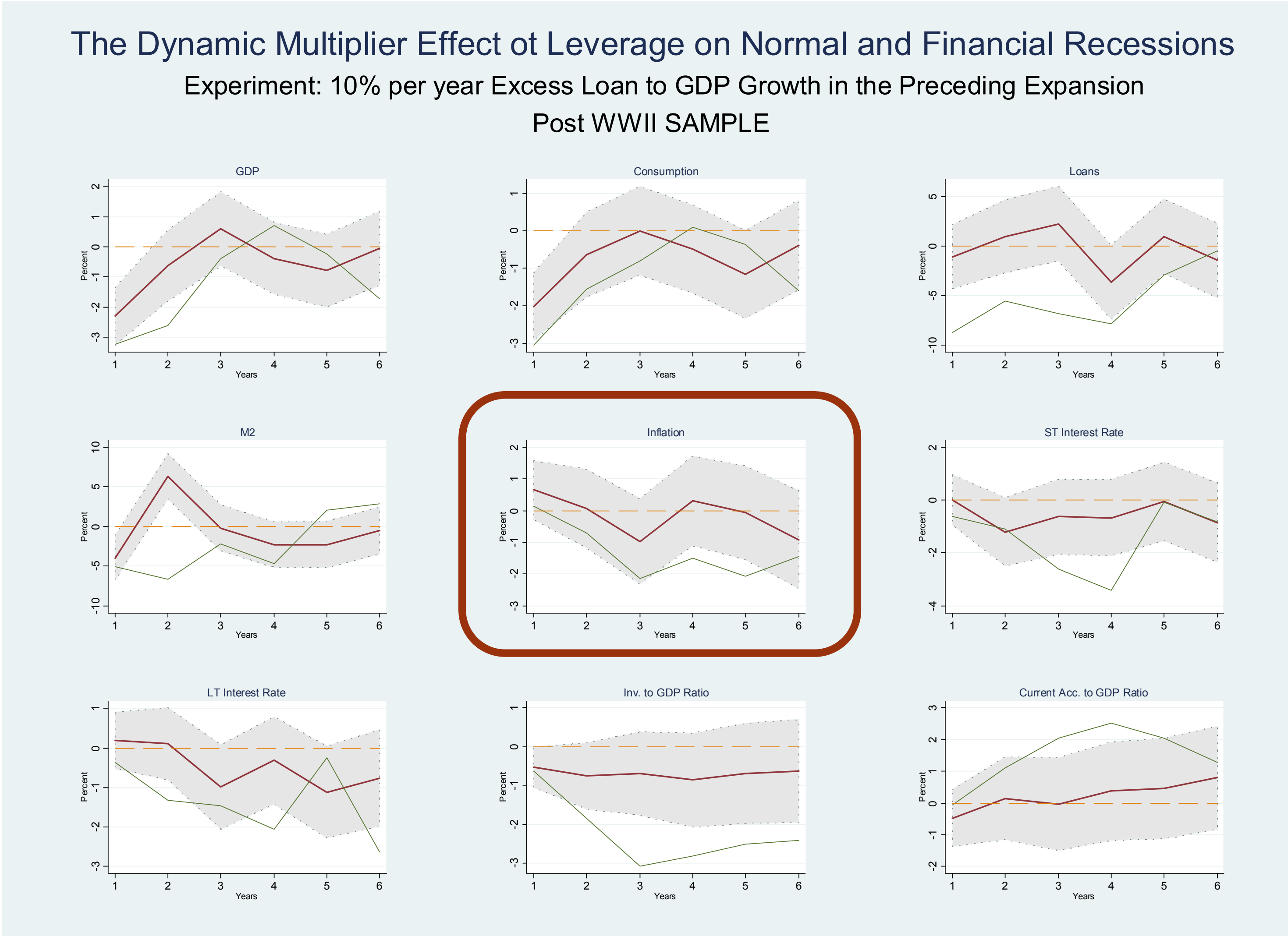




Source:

<u>Lesson 4</u>: In a financial crisis with large run-up in private sector credit, mark down growth/inflation *more*

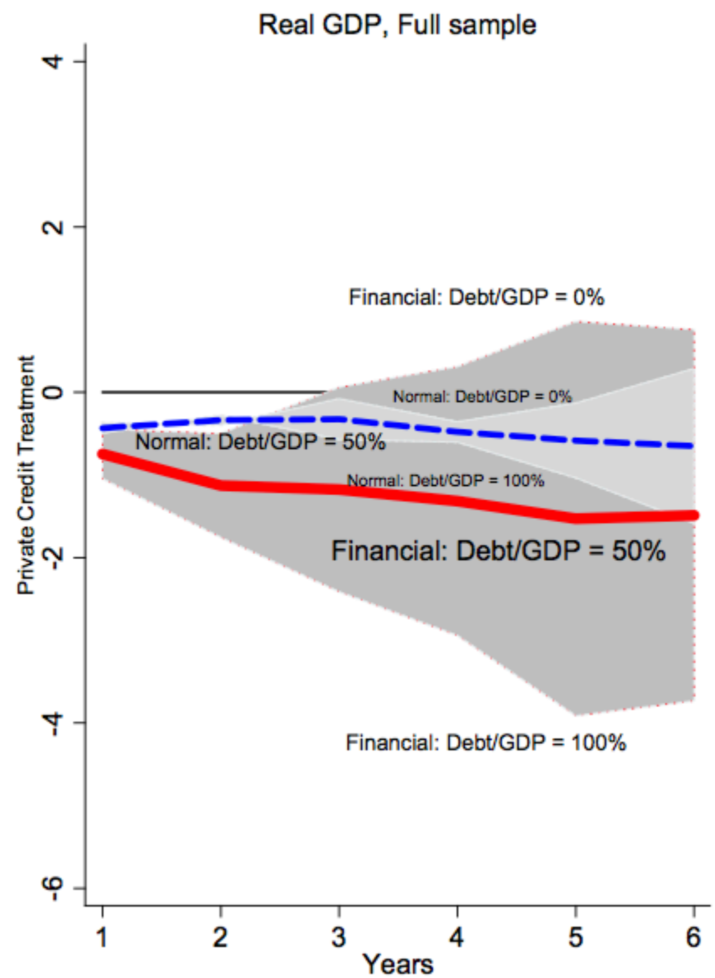
Normal (red) and financial (green) recessions, effect of 10% extra loan-GDP growth run up.



<u>Lesson 5</u>: In a financial crisis with large public debt, and large run-up in private sector credit mark down growth/ inflation *even more*

JST, work in progress

- Zero reference = “no treatment”
- Blue = normal recession after 10% extra credit growth “treatment”
- Red = financial recession after 10% extra credit growth “treatment”
- Lt gray = Blue line path as public debt/GDP vary from 0% to 100%
- Dk gray = Red line path public debt/ GDP vary from 0% to 100%



Summing up the lessons

- Pre-crisis prevention
  - Central bank complacency, with two obvious and key failures
    - Inflation targeting not enough, unable to avert credit boom/bust crisis
      - Didn't we know this already from history of the gold standard, etc.?
    - Not having well thought out banking supervision/resolution, LOLR regime
      - Ditto
  - Both failures present with a vengeance in the Eurozone with amplification factors
    - Supranational "system" with inadequate EZ-level supervision
    - ECB collateral (ex ante/ex post) => money-go-round for boom periphery
    - Vulnerabilities amplified by stance on "no transfers, no default, no bailout, no monetary policy, no fiscal policy, no adjustment union"

- Post-crisis response
  - What will the path look like? Estimate how contractionary and deflationary it is going to be in normal model… Then, for example, double that estimate
    - Massive deflationary shock; CBs beware of premature tightening
    - ECB rate rise in 2011?
    - Fed/BoE/BoJ responses more accomodative, but large headwinds also

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